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Enact Tax Reform Now

PROBLEM

In the first section of this report, the National Taxpayer Advocate identified the complexity of the Internal Revenue Code as the most serious problem facing taxpayers. We described the sources and impact of complexity as well as some of the key obstacles to achieving fundamental reform.¹ In this section, we offer some principles and proposals to streamline the tax code.

RECOMMENDATIONS

As a threshold matter, we note that the terms “tax reform” and “tax simplification” are not necessarily synonymous. The term “reform” suggests a more fundamental revision of the tax code, and in theory, the code could be “reformed” in a way that adds complexity. By contrast, the term “simplification” suggests reducing complexity but does not necessarily imply a comprehensive revision. Simplifying discrete provisions that are particularly confusing for large numbers of taxpayers would fit within this definition.

In the first section of this report, we described the magnitude of the burden the existing tax code imposes. Overall compliance consumes an estimated 6.1 billion hours a year – the equivalent of more than three million full-time workers. The monetary compliance burden for the median taxpayer (as measured by income) comes to more than \$250 a year. The tax code has grown so long that no one can even determine how long it is, with one measurement suggesting it has reached 3.8 million words.

We further discuss the breadth of “tax expenditures,” a term that generally encompasses any reduction in revenue attributable to an exclusion, exemption, or deduction from gross income or a credit, preferential tax rate, or deferral of tax.² Tax expenditures now total about \$1.1 trillion a year. As compared with about 138 million individual tax returns filed in 2010,³ that translates to an average reduction in tax per return of about \$8,000.⁴ Moreover, tax is computed as a percentage of income. Therefore, for example, a taxpayer who pays a 25 percent tax rate may be benefiting from deductions or exclusions from income worth \$32,000 (*i.e.*, a reduction in taxable income of \$32,000 produces a reduction

¹ See Most Serious Problem, *The Time for Tax Reform Is Now*, *supra*.

² Congressional Budget and Impoundment Control Act, Pub. L. No. 93-344, § 3(3) (1974).

³ See IRS 2010 Filing Season Statistics at <http://www.irs.gov/newsroom/article/0,,id=220953,00.html> (last visited Dec. 27, 2010).

⁴ Tax expenditures have interactive effects, so if all tax expenditures were simultaneously eliminated, the change in revenue would likely be somewhat less than \$1.1 trillion. Accordingly, the average tax reduction per taxpayer could be somewhat less than \$8,000. Nevertheless, this total represents a reasonable approximation and is used for illustrative purposes in this report. See Leonard Burman, Eric Toder & Christopher Geissler, *How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?* Discussion Paper 31, Amer. Soc. Sci. Assoc’n (New Orleans, La., Jan. 5, 2008) 3, shorter version published in 98 *Amer. Econ. Rev.* 79 (2008) (stating that despite interaction effects, “commentators have added up tax expenditures to make general statements about their magnitude”).

in tax of \$8,000 when the tax rate is 25 percent).⁵ Few taxpayers recognize the extent of tax expenditures, but because the system is so complex, many suspect that well-advised taxpayers are taking advantage of loopholes while they themselves are paying full freight. Some likely feel justified in “fudging” on their taxes to right the perceived unfairness. This suspicion and cynicism are not good for the tax system, nor for tax compliance. Indeed, among taxpayers who have a choice about reporting their income, compliance rates are well under 50 percent.⁶

For these reasons, the National Taxpayer Advocate has become convinced that fundamental tax reform – not merely *ad hoc* simplification – is required. However, the National Taxpayer Advocate has previously offered numerous simplification proposals that still have merit and should be considered as part of an overall tax reform effort. Below we suggest several fundamental principles that should help guide tax reform and then summarize notable simplification recommendations from past reports.

General Principles

In attempting to reform the tax code, a threshold challenge that the new Congress will face is balancing tax administration considerations with other policy objectives. From a tax administration perspective, tax expenditures are to be avoided. The rationale is simple: Every exclusion, deduction, credit, or other deviation from the general concept of taxing total income at a specified rate of tax introduces complexity into the tax code.

At the same time, we recognize that competing policy objectives exist. For example, the mortgage interest deduction arose from the desire to encourage home ownership; the exclusions for retirement plan contributions and employer contributions for health insurance are designed to increase retirement savings rates and health insurance coverage, respectively; the deduction for charitable contributions aims to encourage taxpayers to support organizations that seek to advance the common good; the earned income tax credit (EITC) seeks to promote work and raise low income families out of poverty. The evidence is mixed concerning the extent to which these tax incentives encourage more of the behavior they seek to induce,⁷ and some of these objectives may be better accomplished through direct expenditures rather than through tax expenditures. Still, tax expenditures are generally motivated by legitimate policy objectives, so Congress must carefully balance the tax administration interests of simplification against other policy priorities.

⁵ Tax expenditures are discussed in more detail elsewhere in this report. See Most Serious Problem: *The Time for Tax Reform Is Now*, *supra*, and *Evaluate the Administration of Tax Expenditures*, vol. 2, *infra*). These sections note that the largest tax expenditures include the exclusion for employer-provided health care, the exclusion for retirement plan contributions and earnings, and the mortgage interest deduction for owner-occupied housing.

⁶ IRS studies show that non-farm sole proprietors report only 43 percent of their business income and unincorporated farming businesses report only 28 percent. See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>). As low as these rates are, they would be even lower if not for the fact that some of this income is reported to the IRS by third parties.

⁷ For a more complete discussion, see *Evaluate the Administration of Tax Expenditures*, vol. 2, *infra*.

Our suggestion is to approach tax reform in a manner similar to zero-based budgeting. To start the discussion, the assumption should be that all tax expenditures would be eliminated. Then a tax benefit would be added back only if a compelling business case can be made that the benefits of providing the benefit through the tax code outweigh the tax-complexity challenges it creates. Factors to consider in making this assessment include whether the government continues to place a priority on encouraging the activity for which the tax incentive is provided, whether the incentive is accomplishing its intended purpose, and whether a tax expenditure is more effective than a direct expenditure for achieving that purpose.⁸

The immediate elimination of certain tax benefits could cause hardships for individuals or businesses where established pricing or conduct is based on those provisions. For example, homeowners paid a purchase price that took into account the federal subsidy provided through the mortgage interest deduction. Sudden elimination of that deduction would cause the value of existing homes to drop substantially. If Congress decides to eliminate tax incentives in situations like this, transitional relief should be provided.

This approach, at a conceptual level, is similar to two other proposals presented during the past year. In December 2010, the National Commission on Fiscal Responsibility and Reform issued a report that, among other things, also recommended a zero-based budgeting approach to tax reform.⁹ In February 2010, Senators Wyden and Gregg introduced legislation that would substantially revamp the tax code.¹⁰ While we do not endorse specific proposals, we think both are thoughtful and worthy starting points.

In addition to suggesting a zero-based budgeting approach to tax reform, we believe the protection of taxpayer rights and minimization of taxpayer burden should be emphasized along with the IRS's ability to administer the law. Toward those ends, we suggest six core principles that should help guide the development of tax reform legislation:

1. The tax system should not “entrap” taxpayers.
2. The tax laws should be simple enough so that most taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute their tax liabilities on a single form, and simple enough so that IRS telephone assistants can fully and accurately answer taxpayers' questions.

⁸ The National Taxpayer Advocate has previously discussed design elements that should be considered when running social benefit programs through the tax code. See National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, *Running Social Programs through the Tax System*.

⁹ See National Commission on Fiscal Responsibility and Reform, *A Moment of Truth*, at 28-34 (Dec. 2010) at <http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform>. The mandate of the commission was to address the nation's long-term fiscal challenges, and as a result, its tax reform recommendations are partly designed to increase revenue. It is beyond the mission of the National Taxpayer Advocate to take a position on these broader fiscal issues. However, we note that the question of whether and to what extent to raise revenue is extremely contentious, and we are concerned that the debate over revenue levels could overshadow and derail meaningful tax reform. Therefore, we suggest it may be more productive for Congress to consider these issues in two steps. First, Congress could enact systemic reforms to the tax code on a revenue-neutral basis. Second, Congress could decide on appropriate revenue levels and adjust the tax rates accordingly.

¹⁰ Bipartisan Tax Fairness and Simplification Act, S. 3018, 111 Cong. (2010).

3. The tax laws should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance.
4. The tax laws should provide some choices, but not too many.
5. Where the tax laws provide for refundable credits, they should be designed in a way that the IRS can effectively administer.
6. The tax system should incorporate a periodic review of the tax code – in short, a sanity check.¹¹

Finally, we offer one recommendation that, while not a general principle, would help make taxpayers more aware of the connection between the taxes they pay and the benefits they receive. We recommend that Congress direct the IRS to provide each taxpayer with a “taxpayer receipt” presenting a general breakdown of how federal dollars are spent.

One commentator has noted:

Sending taxpayers a one-page summary of Federal spending is a big step toward a more rational discussion of debt and deficits. Polls show Americans think over 50 percent of the Federal budget is wasted; liberals think it all goes to wars, conservatives think it all goes to welfare and foreign aid. If people knew that half the budget goes to Social Security, Medicare, Medicaid and interest on the debt, everyone would recognize the need for tough choices on taxes and spending.¹²

From a tax administration standpoint, we believe better awareness of how our tax dollars are spent would increase the sense that “we’re all in this together” and potentially improve attitudes toward tax compliance.¹³

Simplification Proposals

Over the past decade, this office has made numerous proposals to simplify various sections or areas of the tax code. While these proposals were not written with the goal of structural tax reform in mind, they should be considered as part of an overall tax reform process.

Repeal the Alternative Minimum Tax (AMT) for Individuals. Few people think of having children or living in a high-tax state as a tax-avoidance maneuver, but under the unique logic of the AMT, that is essentially how those actions are treated. The AMT effectively

¹¹ The National Taxpayer Advocate previously articulated these principles in a presentation to the President’s Advisory Panel on Federal Tax Reform. See Public Meeting of the President’s Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Nina E. Olson, National Taxpayer Advocate), at <http://www.taxreformpanel.gov/meetings/meeting-03032005.shtml>. For more detail, see National Taxpayer Advocate 2005 Annual Report to Congress 375-380 (Key Legislative Recommendation: *A Taxpayer-Centric Approach to Tax Reform*).

¹² Comment of Steve Novick, posted on website of Senator Ron Wyden at <http://wyden.senate.gov/imo/media/doc/statements.pdf>.

¹³ A “taxpayer receipt” would be relatively easy to generate. The IRS already provides a high-level breakdown of federal spending in the Form 1040 instructions booklet. See Form 1040 Instructions (2009), at 100. This information could be provided in somewhat more detail and mailed or provided electronically to each taxpayer. Third Way, a liberal advocacy group, has promoted the idea, and the Tax Foundation, a conservative group, has supported it. See Laura Saunders, *Tracking Your Federal Tax Dollars*, Wall Street Journal, Nov. 6, 2010, at <http://online.wsj.com/article/SB10001424052748704506404575592900454547226.html?KEYWORDS=%22taxpayer+receipt%22>.

requires taxpayers to compute their taxes twice – once under the regular tax rules and again under the AMT rules – and then to pay the higher of the two amounts. The regular rules allow taxpayers to claim tax deductions for each dependent (recognizing the costs of maintaining a household and raising a family) and for taxes paid to state and local governments (reducing “double taxation” at the federal and state levels), but the AMT rules disallow those deductions. An estimated 77 percent of all additional income subject to tax under the AMT is attributable to the disallowance of deductions for dependents and state and local tax payments. The AMT computations are also extremely burdensome. The National Taxpayer Advocate has recommended that the AMT be repealed. Moreover, we note that if tax expenditures are substantially reduced, the AMT would be rendered largely irrelevant.¹⁴

Consolidate the Family Status Provisions. Notwithstanding the improvements brought about by enactment of a Uniform Definition of a Child in 2004, the tax code’s family status provisions continue to ensnare taxpayers and make tax administration difficult simply because of the number of such provisions and their structural interaction. These provisions include filing status, personal and dependency exemptions, the child tax credit, the EITC, the child and dependent care credit, and the separated spouse rule under IRC § 7703(b). Many of the eligibility requirements – such as support or maintenance costs of the home – are difficult for the IRS to verify without conducting audits into taxpayers’ personal and private lives. The National Taxpayer Advocate has recommended that, as part of a comprehensive reform of the tax code’s tax treatment of families, Congress consolidate the numerous existing family status-related provisions into two categories: (1) a Family Credit and (2) a Worker Credit. The refundable Family Credit would reflect the costs of maintaining a household and raising a family, while the refundable Worker Credit would provide an incentive and subsidy for low income individuals to work.¹⁵

Improve Other Provisions Relating to Taxation of the Family Unit. The tax code currently imposes “joint and several liability” on married persons who file a joint federal income tax return. This concept dates back to the early years of the income tax when a husband was typically the sole wage earner for the family unit. Today, husbands and wives often have separate assets and incomes that they do not equally control. Recognizing that it is inequitable to hold one spouse liable for tax on the other spouse’s income, at least in cases where he or she does not know about the income of the other spouse and does not

¹⁴ The National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in prior reports and congressional testimony since 2001. See National Taxpayer Advocate 2008 Annual Report to Congress 356-362 (Legislative Recommendation: *Repeal the Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-385 (Legislative Recommendation: *Alternative Minimum Tax*); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2001 Annual Report to Congress 166-177 (Legislative Recommendation: *Alternative Minimum Tax for Individuals*); see also *Alternative Minimum Tax: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means* (March 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. on Taxation and IRS Oversight of the Senate Comm. on Finance* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

¹⁵ See National Taxpayer Advocate 2008 Annual Report to Congress 363-369 (Legislative Recommendation: *Simplify the Family Status Provisions*); National Taxpayer Advocate 2005 Annual Report to Congress 397-406 (Legislative Recommendation: *Tax Reform for Families: A Common Sense Approach*).

significantly benefit from it, Congress has enacted relief rules. However, these relief rules are complex, do not always produce the right result, and impose a large burden on the “innocent spouse” to prove his or her case. The National Taxpayer Advocate has recommended several steps to improve equity and simplify the rules, including eliminating joint and several liability for joint filers.¹⁶

The “kiddie tax” rules are another family-related area of taxation that create significant burden for some taxpayers. The tax code currently taxes a minor child’s unearned income above a certain threshold at the parent’s tax rate. The parent must decide whether to file a separate return for the child or include the child’s income on the parent’s own return. The calculations required to determine which option is preferable in a particular case are complex. Moreover, if the child’s parents are separated, additional complications arise. If a custodial parent has been designated, the child’s income must be included on that parent’s return. If no custodial parent has been designated, the law requires the tax to be computed by reference to the return of the parent with the greater taxable income. During a divorce proceeding, however, spouses sometimes conceal their assets or income from the other spouse, making compliance with these rules impractical. The National Taxpayer Advocate has recommended that the unearned income of minor children above a specified threshold be taxed at a higher rate and that the link between the computation of the child’s tax liability and the parent’s tax return be severed.¹⁷

Consolidate Education Savings Tax Incentives. The tax code contains at least 11 separate incentives to encourage taxpayers to save for and spend on education. The eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges, and inflation adjustments vary from provision to provision. The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. However, taxpayers will only respond to incentives if they know they exist and understand them. Few, if any, taxpayers are aware of each of the education tax incentives and familiar enough with the particulars to make wise choices. The National Taxpayer Advocate has recommended that Congress consolidate incentives and harmonize definitions and other terms to the extent possible.¹⁸

Consolidate Retirement Savings Tax Incentives. The tax code contains at least 16 separate incentives to encourage taxpayers to save for retirement. These incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability. Similar to education incentives, the large number of options and lack of common definitions and terms can

¹⁶ See National Taxpayer Advocate 2005 Annual Report to Congress 407-432 (Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse*); see also National Taxpayer Advocate 2001 Annual Report to Congress 128-165 (Legislative Recommendation: *Joint and Several Liability*).

¹⁷ See National Taxpayer Advocate 2002 Annual Report to Congress 231-242 (Legislative Recommendation: *Children's Income*).

¹⁸ See National Taxpayer Advocate 2008 Annual Report to Congress 370-372 (Legislative Recommendation: *Simplify and Streamline Education Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 403-422 (Legislative Recommendation: *Simplification of Provisions to Encourage Education*).

preclude taxpayers from making wise choices or understanding how each incentive works. The National Taxpayer Advocate has recommended that Congress consolidate existing retirement incentives, particularly where the differences in plan attributes are minor. For instance, Congress should consider establishing one retirement plan for individual taxpayers, one for plans offered by small businesses, and one suitable for large businesses and governmental entities (eliminating plans that are limited to governmental entities). At a minimum, Congress should establish uniform rules regarding hardship withdrawals, plan loans, and portability.¹⁹

Simplify Worker Classification Determinations to Minimize Employee-versus-Independent Contractor Disputes. The complexity of, and ambiguities in, the existing worker classification rules create uncertainty and lead to noncompliance. In general, businesses are only required to pay and withhold employment tax, withhold income tax, and provide benefits with respect to employees. Consequently, businesses often classify workers as independent contractors to reduce their costs. Some employees seeking to avoid their tax obligations may also prefer to be classified as contractors if the employer does withhold taxes or report the payments for employees to the IRS. Depending on the terms of the relationship between a business and a worker, however, many workers should be classified as independent contractors. The National Taxpayer Advocate has recommended that Congress (1) replace § 530 of the Revenue Act of 1978 with a provision applicable to both employment and income taxes and require the Secretary to issue associated guidance, including guidance with specific industry focus; (2) direct the IRS to develop an electronic tool to determine worker classifications that employers would be entitled to use and rely upon, absent misrepresentation; (3) allow both employers and employees to request classification determinations and seek recourse in the United States Tax Court; and (4) direct the IRS to conduct outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.²⁰

Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets. The tax code contains more than 100 provisions that are temporary and set to expire soon, up from about 21 in 1992. Tax benefits have increasingly been enacted for a limited number of years in order to reduce their cost for budget-scoring purposes. Tax sunsets make it difficult for both the government and taxpayers to plan ahead, especially when it is uncertain whether Congress will extend a provision that is set to expire. The complexity and uncertainty caused by sunsets make it more difficult for taxpayers to estimate liabilities and pay the correct amount of estimated taxes, complicate tax administration for the IRS, reduce the effectiveness of tax incentives, and may even reduce tax compliance. The National

¹⁹ See National Taxpayer Advocate 2008 Annual Report to Congress 373-374 (Legislative Recommendation: *Simplify and Streamline Retirement Savings Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 423-432 (Legislative Recommendation: *Simplification of Provisions to Encourage Retirement Savings*).

²⁰ See *id.* at 375-390 (Legislative Recommendation: *Worker Classification*).

Taxpayer Advocate has suggested several ways for Congress to reduce or eliminate the procedural incentives to enact temporary tax provisions.²¹

Eliminate (or Simplify) Phase-Outs. More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits as a taxpayer's income increases. There are, in fact, legitimate policy reasons for using phase-outs in certain circumstances. Like tax sunsets, however, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. Moreover, phase-outs are burdensome for taxpayers, reduce the effectiveness of tax incentives, and make it more difficult for taxpayers to estimate their tax liabilities and pay the correct amount of withholding or estimated taxes, possibly reducing tax compliance. Phase-outs also create marginal "rate bubbles" – income ranges within which an additional dollar of income earned by a relatively low income taxpayer is taxed at a higher rate than an additional dollar of income earned by a relatively high income taxpayer. Because Congress could achieve a similar distribution of the tax burden based on income level by adjusting marginal rates, phase-outs introduce unnecessary complexity to the Code. The National Taxpayer Advocate has recommended that Congress repeal phase-outs or at least reassess them individually to ensure that they are necessary to accomplish their intended objective.²²

Streamline the Penalty Regime. The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today. The last comprehensive reform of the tax code's penalty provisions was enacted in 1989, after careful study by Congress, the IRS, and others. Since then, legislative and administrative changes to the penalty regime have proceeded piecemeal, but without the kind of careful analysis conducted in 1989. The National Taxpayer Advocate has recommended that Congress direct the IRS to (1) collect and analyze more detailed penalty data on a regular basis and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. Congress should appropriate additional funds for this research, as necessary. In the meantime, based on penalty reform principles identified in 1989, the National Taxpayer Advocate recommended 11 steps that could be taken immediately.²³

²¹ See National Taxpayer Advocate 2008 Annual Report to Congress at 397-409 (Legislative Recommendation: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*).

²² See *id.* at 410-413 (Legislative Recommendation: *Eliminate (or Simplify) Phase-outs*).

²³ See National Taxpayer Advocate 2008 Annual Report to Congress 414-418 (Legislative Recommendation: *Reforming the Penalty Regime*, and vol. 2 (Research Study: *A Framework for Reforming the Penalty Regime*)).